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No. 81-

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From The Court of Appeal of the State of California for the First Appellate District

JURISDICTIONAL STATEMENT

FRANKLIN C. LATCHAM
COUNSEL OF RECORD
PRENTISS WILLSON, JR.
One Market Plaza
Spear Street Tower, 34th floor
San Francisco, California
94105
Telephone: (415) 777-6000
Counsel for Appellant
Container Corporation of
America

Of Counsel
MORRISON & FOERSTER
One Market Plaza
Spear Street Tower
San Francisco, CA 94105
Telephone (415) 777-6000
September 14, 1981.

BOWNE-PERNAU WALSH • 190 NINTH ST. • S.F., CA 94103 • (415) 864-2300

QUESTION PRESENTED

Whether requiring the income of foreign subsidiaries of a domestic corporation doing business in California to be included in the parent corporation's tax base for determining the income to be apportioned to California for purposes of the California franchise tax is repugnant to the foreign commerce and due process clauses of the federal constitution, and in conflict with well established federal tax policy, when:

1. The foreign subsidiaries are organized and operating exclusively in foreign countries and are not part of a functionally integrated business with the parent and no significant property is transferred between the parent and the foreign subsidiaries; and

2. The inclusion of the foreign subsidiary income in the parent's unitary tax base results in a significant distortion of the parent's taxable income and double taxation of the foreign subsidiary income through misattribution of that income to California.

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JURISDICTIONAL STATEMENT

Appellant, Container Corporation of America ("Container") appeals from the judgment of the Court of Appeal, of the State of California for the First Appellate District, ("Court of Appeal"), which upheld the right of the Franchise Tax Board of the State of California, in determining the taxable income of appellant to be apportioned to California, to include the income of subsidiaries of Container organized and operating exclusively outside the United States. Pursuant to Supreme Court Rule 28.1 a list of Container's parent and non 100 percent owned affiliates is found at Appendix C below.

OPINIONS BELOW

The opinion of the Court of Appeal (Appendix A) is reported at 117 Cal.App.3d 988, 173 Cal.Rptr. 121 (1981). The memorandum opinion and judgment of the California Superior Court (Appendix B) are not reported.

JURISDICTION

The Court of Appeal rendered its opinion and judgment on April 17, 1981, affirming the California trial court's judgment. Appellant's petition for rehearing was filed April 29, 1981, and was denied by the Court of Appeal on May 4, 1981 (Appendix D). Appellant's petition for hearing in the California Supreme Court was filed May 22, 1981, and was denied June 17, 1981 (Appendix E).

A notice of appeal was filed in the Court of Appeal on July 31, 1981 (Appendix F). The time within which to docket this appeal in this Court expires on September 15, 1981, and timely docketing has been made. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(2).

CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS

California Revenue and Taxation Code, Section 25101 provided (during the tax years at issue, 1963-1965) as follows:

> When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll,

> value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State. . . .

California Administrative Code, title 18, section 25120(b) is set forth in Appendix G.

The relevant provisions of the Constitution are the Foreign Commerce Clause (U.S. Const. art. I, § 8, cl. 3), and the Due Process Clause of the Fourteenth Amendment.

STATEMENT

1. California imposes a franchise tax based on net income on corporations doing business in California. The tax base for a single corporation or a unitary group of corporations doing business in several states is apportioned according to the familiar payroll, property and sales factors formula. Unlike most other states in the United States[1], however, California also includes separately incorporated subsidiaries operating exclusively in foreign countries in the tax base to be apportioned where the corporations are determined to be unitary.[2] This appeal challenges

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[1]Carlson, *State Taxation of Corporate Income From Foreign Sources*, in Essays in International Taxation (Tax Policy Research Study Number Three, Department of the Treasury), 231, 245 n.1 (1976), citing Rudolf, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 Tax L. Rev. 171 (1970).

[2]In addition, California includes a foreign parent and its affiliates operating exclusively in foreign countries in the tax base where a subsidiary is operating in California. Appeal of Beecham, Inc. Cal. Tax Rep. (CCH) ¶ 205-635, Cal. State & Local Tax Serv. (P-H) ¶ 13,102-I (St. Bd. Equal. 1977).

the constitutionality of the latter where the foreign subsidiary is not functionally integrated with the parent and misattribution of income to the parent results and where the California method contradicts federal tax policy.

2. Container is a domestic corporation headquartered in Chicago, Illinois. During the relevant years (1963-1965), Container engaged in the production and distribution of paperboard and paperboard-based packaging in the United States. Container also owned controlling interests in twenty corporations located in Western Europe, Mexico, Colombia and Venezuela engaged in the same line of business. Stip. ¶ 26.[3] Container does business in California and filed a unitary franchise tax return including income from all its domestic operations.

The operations of the foreign subsidiaries were highly decentralized so that the subsidiaries located in each particular country operated as a fully integrated autonomous business rarely crossing the borders of their own country. Stip. ¶ 61. Personnel, including management of the foreign subsidiaries, were comprised almost exclusively of citizens of the countries involved. Stip. ¶ 74. In most of the Latin American subsidiaries, local investors held substantial minority stock interests. Stip. ¶ 25. The degree to which the foreign subsidiaries operated as independent businesses is illustrated by the following facts:

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[3]References are to paragraphs of the Stipulation of Facts ("Stip.") found in the Clerk's Transcript on Appeal ("C.T.") at 147-169 and 181-263. This case was presented to the trial court entirely on stipulated facts plus a single expert witness. Appellant will request that the record in the case be transmitted to the Court.

Flow of Goods. Container purchased no raw materials and no finished products from the foreign subsidiaries. Stip. ¶ 26. A small percentage of paperboard or raw material requirements of various subsidiaries was purchased at arm's-length prices by those subsidiaries from Container. Stip. ¶¶ 141, 143. In all cases the materials could have been obtained from other sources. Stip. ¶ 141.

Managerial Relationship. The management of the foreign subsidiaries had complete authority and control over business decisions. Stip. ¶ 74. The involvement of Container management in decisions affecting the foreign subsidiaries was limited to decisions about capital appropriations such as the expansion of a facility involving a major capital expenditure. Stip. ¶ 74.

Exchange of Technology. Beyond the initial efforts involved in establishing the foreign subsidiaries,[4] which occurred many years before the years in suit, Container provided its subsidiaries with little material assistance in developing paperboard and packaging technology which, in any event, is widely known throughout the industry. Stip. ¶¶ 76, 83, 85, 146. Pursuant to technical service agreements or more informal arrangements with Container, unless prohibited by local law, Container charged its foreign subsidiaries for all information provided under these agreements. Stip. ¶¶ 66, 144-146.

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[4]Approximately half of the subsidiaries were purchased as established, ongoing businesses.

Exchange of Personnel. The foreign subsidiaries operated independent personnel departments. The number of employees who transferred from Container to a foreign subsidiary were very few. During the period in question, only twenty-six former Container employees were working for foreign subsidiaries, compared with the approximately 13,400 persons employed by Container and the 6,800 persons employed by the foreign subsidiaries. Stip. ¶ 119.

Loans. The foreign subsidiaries generally obtained financing from local sources without involvement by Container. In certain instances, Container guaranteed those loans. Container made direct loans to the subsidiaries for less than one-third of their financing. Stip. ¶ 133.

Centralized Services. There were no substantial centralized services performed by the parent for the subsidiaries (or vice versa) such as a central personnel, purchasing, advertising, marketing or accounting department. Stip. ¶¶ 134-150.

3. During the tax years at issue, the income of Container excluding foreign subsidiaries was $25,362,000, $28,975,000, and $30,027,000. Over Container's objection, California insisted that the income of the foreign subsidiaries be included in Container's tax base, increasing the tax base to $36,158,000, $43,055,000 and $45,916,000, respectively.

4. Container commenced this refund action on April 8, 1974 in the Superior Court of the State of California for the City and County of San Francisco. The complaint was based upon, and incorporated, claims for refund previously filed by Container and denied by the California Franchise

Tax Board. The claims demanded refunds upon the ground that the state is prohibited from including these foreign subsidiaries in a unitary return with Container under the due process and foreign commerce clauses of the Constitution.[5] From the earliest stage of the proceedings Appellant has raised the constitutional claim that Section 25101 of California Revenue and Taxation Code, on its face and as applied to the instant facts, is repugnant to the foreign commerce and due process clauses of the Constitution. Both the Superior Court and the Court of Appeal specifically rejected each of the due process and foreign commerce clause claims (App. A, *infra*, A-17 to A-26; App. B, *infra*, A-31).

THE QUESTION PRESENTED IS SUBSTANTIAL

I

THE DECISION BELOW INCORRECTLY DECIDES IMPORTANT CONSTITUTIONAL QUESTIONS, NOT PREVIOUSLY DECIDED BY THIS COURT, WHICH ARE SQUARELY PRESENTED IN THIS CASE

This case squarely presents to the Court for the first time the Constitutional conflicts, including conflicts with federal tax policy, surrounding California's expansion of the unitary apportionment method to include the income of foreign subsidiaries not doing business in the United States in the tax base against which the State's income tax is measured.

Under its unitary apportionment method, California treated Container and its foreign subsidiaries as if all

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[5]The complaint and claims also raised issues of California law not relevant to this appeal.

companies were engaged in a single business earning one income which could be apportioned to California on the basis of a three factor formula comparing the property, payroll and sales in California with the total world-wide property, payroll and sales of CCA and its subsidiaries.

The correct method for use in this case is the arm's-length method *vis-a-vis* Container and its foreign subsidiaries wherein the income of the subsidiaries is determined independently of the parent and the adequacy of intercompany charges is determined by an arm's-length standard. This arm's-length method is used both by the United States and the principal trading nations of the world (including those countries in which the foreign subsidiaries operated) in dividing income between the affiliated corporations operating in different countries. The use by California of a world-wide unitary apportionment method results in a significant distortion of Container's taxable income, double taxation of the foreign income of Container's subsidiaries and creates serious conflicts with federal tax policy.

A. The Considerations Enunciated In Japan Line Apply to the Foreign Commerce Clause Issue In This Case and Require Use of the Arm's-Length Method

In *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), this Court emphasized the special considerations attendant to state taxation of foreign commerce (as compared to interstate commerce):

> When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations

> beyond those articulated in *Complete Auto,* come into play. The first is the enhanced risk of multiple taxation.
>
> • • •
>
> Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. 441 U.S. at 446-48.

In *Japan Line* both the Court's opinion and the brief of the United States as amicus curiae addressed the specific question of the validity of the apportioned county property tax as applied to the containers owned by Japanese shipping companies. Both the Court, and the United States in its brief, determined that the property tax was invalid because of the problems of multiple taxation and interference with federal uniformity, relying upon cases involving many types of state taxes including state income taxes. Both the Court and the United States left open the question of whether these additional considerations should apply equally to other state taxes when determining their validity under the commerce clause. The decision below construes *Japan Line* as limited to the property tax involved in that case. Appellant submits that both additional considerations apply equally to state corporate income taxes.

1. Double taxation results because the income of the foreign subsidiaries is taxed in their respective countries on an arm's-length basis, *i.e.*, the income earned by a particular subsidiary was taxed in its country of operation without reference to income of its domestic parent. Stip.

¶¶ 139-140. By contrast, California taxed the apportioned segment of the world-wide income, taking into account the same income (before foreign tax) of the foreign subsidiaries which has already been taxed in those foreign countries. This results in a double tax burden on income from foreign commerce to which domestic commerce is not exposed.

Double taxation can be illustrated by application of California's own apportionment formula. That is to say, if one applies the three-factor formula with the numerator being domestic payroll, property and sales and the denominator being world-wide payroll, property and sales, and if the percentage produced by averaging those three fractions is multiplied by world-wide income, the result is the following increase in domestic Container income over that reported to the Internal Revenue Service for domestic Container operations:

1963	1964	1965
$2,407,000	$3,996,000	$5,466,000

This double taxation is confirmed by a comparison of the income attributed to the various countries under an arm's-length analysis with that assigned to the countries by the use of California's apportionment formula.[6]

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[6]This method of using the California formula to determine the income attributable to the parent and subsidiary was approved by the California Supreme Court in *Safeway Stores, Inc. v. Franchise Tax Board*, 3 Cal.3d 745, 754, 91 Cal.Rptr. 616, 621 (1970).

	Average Pre-Tax Income per Arm's-Length in Different Countries 1963/64/65	Average Pre-Tax Income per World-Wide Apportionment 1963/64/65
CCA (United States)	$28,121	$32,068
Colombia	4,254	2,203
Mexico	1,605	1,430
Venezuela	4,246	1,907
Panama	1,286	—
Austria	(13)	11
Germany	1,793	2,906
Holland	384	197
Italy	34	968
Total Foreign	13,588	9,642
Total Combined	$41,710	$41,710

000's omitted—Sch. VI to Exh. 1, Stip. re Testimony, C.T. 289.

Multiple taxation is illustrated from the fact that the apportionment formula attributes to other countries approximately one-half of the income produced in Colombia and Venezuela according to arm's-length principles applied in those countries. In Colombia's case, for example, this produces the ludicrous result of apportioning about the same pretax *income* to Colombia as the Colombian subsidiaries paid in Colombian income *taxes*. The *income* attributed to Colombia by the California formula for the years in question is, respectively, $1,960,000, $2,454,000, $2,195,000. For the same years, the actual Colombian tax liability was determined to be $2,508,036, $2,533,755, and $1,484,104, respectively.[7] This is a severe dislocation of the tax base.

[7]Second Addendum to Stip. ¶ 159, C.T. 147-149. As a further example, by application of its formula California has alleged that on average for the years in issue only $197,000 of income can be attributed to the Dutch subsidiary. In fact, the Dutch subsidiary paid Dutch taxes on the basis of $384,000 per year. The actual taxes paid to the Dutch government averaged 97 percent of the income attributed to Holland by the California formula. *Id.*

The decision below dismissed the consequences of multiple taxation as resulting merely "from the imposition of two different methods of calculation. . . ." App. A, *infra*, 24. That distinction is hardly persuasive. While different methods will inevitably lead to a certain unavoidable degree of multiple taxation, the California system is so severe a departure from the internationally customary method that the system guarantees severe and systematic dislocations. Furthermore, as in *Japan Line*, this case presents a situation "where true apportionment does not exist and cannot be policed by this Court at all." (441 U.S. at 455) Certainly this Court cannot require the sovereign countries involved here, any more than it could Japan, to change their apportionment systems.

2. The second additional consideration identified by the Court in *Japan Line* was the impairment of federal uniformity:

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with

> one voice' in regulating foreign commerce. 441 at 450-51.

The application of those principles to this case is striking. California's novel world-wide unitary approach also creates an asymmetry in the international tax structure since the custom of nations has been to determine taxable income based on the arm's-length method. California, like Los Angeles County, has imposed a dramatically different method of determining taxable income upon the international community creating a climate where "international disputes over reconciling apportionment formulae may arise." 441 U.S. at 450. The "if other states followed . . ." language quoted above is particularly appropriate since other states have already followed California's lead. See page 25, *infra*.

In considering this aspect of *Japan Line* it is important to focus on the international tax structure and federal policies in regard thereto. In both federal legislation and tax treaties entered into with the principal trading countries of the world, the United States has developed clear policies based upon recognizing United States corporations and their subsidiaries operating in foreign countries as separate entities with separate incomes. California's unitary apportionment method, which starts from the total world-wide income of Container and its foreign subsidiaries, is in sharp contrast to such federal policies. Successive Assistant Secretaries of Treasury for Tax Policy testified at different times to Congress and commented on the effect of California's approach as follows:

> In this connection I would note that the arm's-length standard is the internationally accepted norm for

> apportioning income between related taxpayers. It is confusing to other countries and disconcerting to international relations when our states use a different standard.[8]
>
> The practice [of requiring a world-wide unitary report] has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary system differs from the arm's-length method used by the Federal Government and generally accepted in international practice.[9]

By apportioning Container's income on a combined, world-wide basis that includes the income of Container's foreign subsidiaries, California has employed a mode of taxation that is inconsistent with the well-established federal system for determining the amount of income arising within this country. Further, to the extent that the unitary method produces an amount of taxable income for the United States operations of Container which exceeds the amount determined on an arm's-length basis (which is true in Container's case for each of the years in issue), then necessarily California will be taxing foreign source income as that term has been defined and recognized for federal

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[8]Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines Before the S. Comm. on Foreign Relations, 95th Cong., 1st Sess. 33 (1977) (Statement of former Assistant Secretary of Treasury for Tax Policy, Laurence N. Woodworth) [hereinafter "Woodworth"].

[9]Hearing on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 3, 7 (1980) (Statement of Donald C. Lubick, former Assistant Secretary of Treasury for Tax Policy) [Hereinafter "Lubick"].

income tax purposes, as well as by other countries. Thus, the decision below is inconsistent with *Japan Line*.[19]

B. The Extension of Unitary Apportionment to Container and Its Foreign Subsidiaries Produces Such Misattribution of Foreign Source Income to California as to Violate the Due Process as Well as Foreign Commerce Clauses

There are no decisions of this Court which have considered the constitutionality of including in the tax base income of a foreign subsidiary (or parent) not engaged in business in the United States. Indeed, there are only two decisions of this Court in which, to our knowledge, income derived in a foreign country was taken into account in making an apportionment that was upheld over due process and commerce clause objections. Both are distinguishable. The first is *Bass, Ratcliff & Gretton Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), involving an English corporation, which brewed ale in England and sold it in the United States. Significantly, no question concerning a subsidiary was present because all operations were conducted

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[19]The error below is underscored by a recent decision of the United States District Court for the Northern District of California in which a British parent with a United States subsidiary challenged the application of California's unitary approach. Judge Renfrew dismissed the suit on procedural grounds but questioned the validity under *Japan Line* of California's unitary approach, as follows:

> ". . . the Court has substantial question as to the ultimate constitutionality of the California unitary tax being applied to foreign corporations with foreign subsidiaries, particularly in light of *Japan Lines*. . . ." *Capital Industries—EMI, Ltd. v. Bennett, et al.*, No. C-79-2145 (N.D. Cal. 1980), *appeal docketed*, No. 80-4114 (9th Cir. Mar. 13, 1980).

by a single corporate taxpayer. Moreover, the taxpayer adduced no proof of misattribution of income to New York, the taxing state. Instead, it rested its entire challenge to the constitutionality of the tax on the fact that the apportionment attributed net income to New York, whereas for federal income tax purposes, the company's domestic operations showed a loss. In contrast, the record in this case establishes the requisite factual basis for a determination that, as a result of the world-wide apportionment, there has been substantial misattribution of foreign source income of Container's subsidiaries to its California tax base.

The other Supreme Court decision in which foreign source income was included in an apportionment was the recent decision in *Mobil Oil Co. v. Vermont*, 445 U.S. 425 (1980) sustaining the power of a State to tax dividends declared by foreign subsidiaries to a domestic parent corporation. *Mobil* did not involve unitary combination. In this case, Container does not challenge the inclusion of dividends in the income of the domestic corporation. Rather, here the issue is the inclusion of the total income of the foreign subsidiaries. Although in *Mobil* the Court stated that the income of a business "operating in interstate [or foreign] commerce is not immune from a fairly apportioned state taxation," Mobil had "disclaimed any dispute with the accuracy or fairness of Vermont's apportionment formula". *Id.* at 434-36. *The dispute disclaimed by Mobil, however, is precisely the issue raised by Container, namely, that the California worldwide apportionment is inaccurate and unfair, both inherently and as applied to the facts of this case.*

The extension of apportionment to Container's operations in foreign countries results in substantial misattribution to California of income derived from foreign sources. This result may be expected in many cases. A widespread consensus has been reached among the states that the three factor formula is an acceptable and equitable method of dividing the taxable income of multistate enterprises among the states. The premise on which that consensus was forged is that a dollar of payroll or property expended or used in one state, and a dollar of sales realized in one state, typically produced roughly the same amount of income as a dollar so spent or sales made in other states. However, when apportionment is extended to foreign countries the premise is no longer true. Hence, the attempted extension of the three factor formula beyond the borders of the United States produces an unreasonable result. The Court below failed to recognize this vital difference between operations within the domestic United States and operations that are extended to include foreign countries. The Court relied upon decisions involving operations within the United States, and upon *Mobil* and *Bass Ratcliff* which are distinguishable as pointed out above (App. A, *infra*, A-20).

Distortion is apparent from the record in this case. First, as described at pages 10-11, *supra*, formula apportionment when applied to the world-wide income of Container and affiliates attributes significantly more income to the domestic operations of Container than was determined for federal income tax purposes by applying the sophisticated accounting techniques prescribed by the Internal Revenue Service.

Second, there are significant differences in the wage rates of workers in countries other than the United States. Because wages are one of three factors used in formula apportionment, the formula inflates the profits apportioned to United States operations where wages are higher.[11] The studies noted below are confirmed by Container's own experience. Container's workers in California are paid 2½ times the amount paid to workers in Colombia to produce the same quantity of corrugated containers. Stip. re Testimony (Kucharvy) C.T. 269-91; Sch. II to Stip. C.T. 285; Reporter's Transcript at 58. [Hereinafter "R.T."]

Third, the formula leads to misattribution of income because of the significant differences in profitability be-

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[11]The major differences in the wage rates of United States workers and those of other countries are well known and widely discussed by spokesmen of industries facing increased competition from lower-priced imports. See table set out in App. H, A-41. These differences in wage rates are not offset by different levels of productivity of workers in various economic settings. *See* table set out in App. I, A-43. These studies are confirmed by other sources. As stated in Peterson, *California Franchise Tax: Combined Income Report Affects Foreign Companies,* 44 J. Tax. 184, 187 (1976):

> . . . wage levels are considerably lower in Japan, Italy or almost any other country than in the United States for the same work. In 1969, the cost of engineering work in Japan was only 70% of that in the U.S. (England was 75%, Holland 80%, France 90%). . . .
>
> The same type of disparity exists as to the cost of plant or property. For example, . . . in 1964-70, the average investment needed to provide employment to one person in the rubber industry in the U.S. was $137,000, while an average of only $58,000 was required outside the U.S.
>
> An apportionment of worldwide income based on property and payroll could never, under these circumstances, properly apportion the income to the local activities which produced it.

tween domestic and foreign operations. This is demonstrated by Container's own experience since the company sought a higher rate of return on its foreign investments (Stip. re Testimony (Green) C.T. 293) and its foreign subsidiaries were substantially more profitable than Container. See Schedules to Stip., V, VI and VII, C.T. 288-91, for a variety of methods demonstrating the higher rate of return from the foreign subsidiaries. The expert testimony of Professor McDonald of Stanford University (which was not disputed by the state) confirms that the foreign operations can be expected to be more profitable than the domestic operations, and that the California formula does not take these differences into account.[12] Multinational corporations expect a higher rate of return on a foreign investment than on a similar domestic investment and it is achieved even after accounting for all losses. Such higher return is required because of the much greater risks involved in foreign operations; it is achieved for several reasons including lower labor costs, rapidly expanding

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[12]The same conclusion was reached by Assistant Secretary Woodworth: "Moreover, the unitary apportionment system as a means for determining the state taxation base of a multinational corporation is highly imperfect and a poor substitute for the arm's-length standard. Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. *The result is tantamount to taxation by a state government of the foreign income of a foreign corporation.*" Woodworth at 34. (Emphasis added).

economies, and a greater market share. R.T. 12-20, 21-23, 33-34. Furthermore, Professor McDonald testified that the differences in economic conditions between the United States and the rest of the world are not temporary or short-term in the way differences within the United States are. R.T. 45.

In *Norfolk & Western Railway v. Missouri State Tax Commission*, 390 U.S. 317 (1968) this Court, noting that the apportionment formula used by the State might be constitutional under other facts, concluded that it was unconstitutional as applied:

> The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most circumstances, may produce a tolerable product. *Id.* at 327.

The record in this case demonstrates that the formula leads to an unacceptable level of distortion so as to violate due process. In a similar circumstance the Court in *Norfolk* fashioned a burden of proof to meet the situation before it:

> We repeat that it is not necessary that a state demonstrate that its use of the mileage formula has resulted in an exact measurement of value. But when a taxpayer comes forward with strong evidence tending to prove that the mileage formula will yield a grossly distorted result in its particular case, the State is obliged to counter that evidence or to make the accommodations necessary to assure that its taxing power is confined to its constitutional limits. If it fails to do so and if the record shows that the taxpayer has sustained the burden of proof to show that the tax is so excessive as to burden interstate commerce, the taxpayer must prevail. *Id.* at 329.

The record in this case establishes such "strong evidence." Since that evidence has been presented by Container and not rebutted by the State, the decision below is in error.

C. Due Process Requires that the Operations Treated as Part of the Unitary Business Must Be "Functionally Integrated" in a Substantial Manner Well Beyond What Exists in this Case

Even if the Court concluded that California's formula could be extended to include some foreign subsidiaries of a domestic corporation, it is clear from the prior decisions of this Court that there must be functional integration of the operations which are to be treated as unitary.

As the summary of facts above makes clear, the court below relied upon a series of trivial connections which are constitutionally insufficient to establish a unitary business.[13] Indeed, if the decision is allowed to stand, it is clear the test for a world-wide unitary business among

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[13]In the process the decision below ineffectively attempted to explain away the lack of the significant interrelationships which would have justified the decision. For example, the admittedly "low level of product exchange" was explained away because of the "nature of the business, high transportation costs and import restrictions" (App. A, *infra*, A-14); the independence of the subsidiaries in their "management, production and distribution" was explained by Container's organizational framework which "calls for decentralization even in its United States operations" (App. A, *infra*, A-14). The decision also relied heavily upon its erroneous characterization (App. A, *infra*, A-12) that "major policy decisions of the subsidiaries were subject to review by [Container]", failing to note the uncontroverted, stipulated facts that the management of the foreign subsidiaries had complete authority and control over business decisions and the involvement of Container management was limited to decisions about capital appropriations. Stip. ¶ 74.

affiliated corporations in the same line of business will have evolved to little more than that of common ownership. Lacking any substantial facts demonstrating functional integration, the court below relied on a presumption in the California regulations that "[a] taxpayer is generally engaged in a [unitary] business when all the activities are in the same general line." California Administrative Code, title 18, section 25120(b). (App. G. A-39). The record in this case amply establishes that there is no unitary business.

By contrast, all the decisions of this Court considering the nature of a unitary business have involved fact patterns where the functional integration, centralization of management, and economies of scale were apparent.[14] For example, in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 224 (1980) at 224 the Court noted "this case involves a highly integrated business which benefits from an umbrella of centralized management and controlled interaction." It is clear that the rationale for apportionment of *unitary* business income is lacking where foreign subsidiaries constitute *discrete* business enterprises. In *Butler Bros. v. McColgan*, 315 U.S. 501, 508-509, the taxpayer lost because it had not shown "that income unconnected with the unitary business ha[d] been used in the formula." Similarly, in *Bass, Ratcliff*, the company profits

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[14] *Bass, Ratcliff, Underwood Typewriter v. Chamberlain*, 254 U.S. 113 (1920), *Hans Rees', Sons Inc. v. North Carolina*, 283 U.S. 123 (1931), *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), and *Exxon* (all involving vertically integrated manufacturing and selling); *Butler Bros.* (centralized purchasing of inventory).

were seen to derive from "a series of transactions beginning with the manufacture in England and ending in sales in New York and other places . . . ," 266 U.S. at 282.

This case invites the Court to draw the constitutional line more precisely in the context of foreign subsidiaries which can be said *not* to "contribute" to a world-wide "enterprise." *Id.* at 435. The decision below rejected (App. A-12) the "bright line" standard Container urged upon the court, namely that there must be a substantial transfer of products. Other state courts, as well as the leading commentator, have concluded that flow of products must exist for a business to be unitary.[15] Whatever standard this Court adopts in this or subsequent cases it should not include the instant situation where there exists only ownership, an administrative presumption in the event of similar businesses and a limited number of insubstantial connections.[16]

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[15] *Commonwealth v. ACF Industries, Inc.*, 441 Pa. 129, 271 A.2d 273 (1970); *Ash Grove Cement Co. v. Department of Revenue*, [1977 Transfer Binder] Or. T.R. (CCH) ¶ 203-221 (1977); Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 Nat'l Tax J. 487, 501-502 (1968).

[16] "California tax authorities appear to construe the definition of a unitary business very broadly, so that related entities which appear to be independently engaged in very different kinds of activities are aggregated into a unitary business and must be included in a combined report to the tax authorities." *Woodworth* at 32. *See also:* Hearings Before the Subcomm. on State Taxation of Interstate Commerce of the Comm. on Finance, 93rd Cong., 1st Sess. 433, 434 (1973). (Statement by John S. Nolan, former Deputy Assistant Secretary of Treasury for Tax Policy.)

II

THE DECISION BELOW PERMITS AND ENCOURAGES A CONTINUING AND SUBSTANTIAL DISCRIMINATORY TAX BURDEN ON MULTINATIONAL CORPORATIONS AFFECTING AMERICA'S FOREIGN COMMERCE AND CONFLICTS WITH WELL-ESTABLISHED FEDERAL POLICY

As described at pages 12-15 *supra*, a substantial conflict exists between federal policy for allocating and apportioning income of affiliated corporations between the United States and foreign countries (the arm's-length standard) and the California apportionment approach (the unitary method) at issue in this case. The arm's-length standard is also "the internationally accepted norm" for such apportionment.[17]

The California approach has already led to complaints from foreign governments, including the United Kingdom, France and Canada, lodged of course with the federal government.[18] It is apparent that it "affects international relations in a persistent and subtle way." *Zschernig v. Miller*, 389 U.S. 429, 440 (1968). As described at pages 13-14 *supra*, recent Assistant Secretaries of the Treasury for Tax Policy have testified to the confusion and irritation to other countries which the California approach creates.

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[17] *Woodworth*, at 33. See also Article 9(1) OECD Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital (1977).

[18] Opposition of a number of foreign governments is noted in *Lubick*, at 10.

This conflict between the federal system and the unitary system employed by California is not merely concerned with the State of California. At least six Western states, plus Illinois and recently New York (as to oil companies)[19] are presently following California's example. We understand that world-wide unitary tax bills are under consideration in Rhode Island, Minnesota, and Massachusetts. This Court should accept this case to determine if world-wide application of the unitary method as utilized by California and a growing number of other states conflicts with federal policy and adversely affects foreign commerce.

The impact on foreign commerce is evident. One of the key elements in the international economic policy of the United States is to encourage the free flow of capital and technology among the international community and to eliminate double taxation. To reduce or eliminate these impediments, the federal government has adopted a statutory scheme and entered into various bilateral treaties designed to promote free trade by harmonizing U.S. tax policy with that of our trading partners. As stated by former Assistant Treasury Secretary Edwin S. Cohen:

> We have at the present time some 20 income tax treaties with foreign countries and about a dozen estate tax treaties, and we consider that these are quite important for the purpose of preventing double taxation by two or more countries of income and estates, and

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[19]The bill (introduced as S. 7093 and A. 9057) was signed by the Governor, July 11, 1981.

by eliminating this double taxation we remove fiscal barriers to international trade and investment.[20]

It is precisely those fiscal barriers which California and other states are establishing. These barriers are not merely academic. The California administration has been told by Japanese industrialists that world-wide unitary tax requirements "were major obstacles to additional Japanese investment in California."[21] At hearings held by the California Assembly Revenue and Taxation Committee in 1979, representatives of several corporations testified that the application of the unitary approach worldwide kept them or others from locating certain facilities in California.[22]

Finally, the stakes are high. The amount of foreign exports from California has been estimated at $8 billion[23] in 1976. The California Franchise Tax Board estimates that it would have lost in 1974 approximately $125 million in franchise tax revenues if it were unable to continue apply-

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[20]Hearings on Tax Conventions with Belgium, Finland, Trinidad and Tobago, and The Netherlands, Before the S. Foreign Relations Committee, 91st Cong. 2d Sess., 2 (1970).

[21]Blankenship, *California's Unitary Tax System—Does It Make Sense*, Cal. CPA Q. 18, 19 (December 1978).

[22]Cal. Assembly Revenue and Taxation Comm., Bank and Corporation Tax, Vol. III, *Unitary Apportionment and World-Wide Combination*, Xerox (101-104); IBM (123-125); Eli Lilly & Co. (126-127); Lloyds Bank (39-40); B.A.T. Industries (47, 54); Rolls-Royce (60); testimony by representative of California's own Department of Economic and Business Development (57-63) (1979).

[23]U.S. Industry and Trade Administration, Dep't of Commerce, State Export Series, *California Exports* 3 (1978).

ing the unitary theory worldwide.[24] The former Assistant Secretary of Treasury for Tax Policy has suggested that such an estimate "may be an indication that unitary apportionment does, in fact, result in unjustifiable extra-territorial taxation."[25] Container agrees.

CONCLUSION

For these reasons, this Court should note probable jurisdiction of the appeal.

Dated: September 14, 1981

Respectfully submitted,

FRANKLIN C. LATCHAM
COUNSEL OF RECORD
PRENTISS WILLSON, JR.
Counsel for Appellant
Container Corporation of America

Of Counsel
MORRISON & FOERSTER

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[24]Calif. Assembly Revenue and Taxation Committee, Bank and Corporation Tax, Vol. V, *Unitary Method of Apportionment: A Second Look* 29 (1980).

[25]*Woodworth* at 34.